

## Chapter 10 Labor and Migration

### Take home messages for Chapter 10

1. The labor market is highly dual, with a formal sector offering wages above the full employment equilibrium, and surplus labor accumulating in the informal sector with low wages and harsh work conditions.
2. Migration is an integral component of development, involving both rural-urban and international population movements.
3. The Todaro model explains domestic migration as a labor market failure, whereby high formal sector wages induce migration of individuals until unemployment is sufficient to lower the expected wage to the current wage in the emitting rural areas. Migration can thus continue to occur even with very high levels of unemployment.
4. Migration decisions are generally part of a household strategy, where the migrant is expected to send remittances back to the emitting household. This requires understanding why migrants remit, and there are many motivations involved from altruism to trade.
5. The new economics of migration looks at sending a migrant as a way for the household to overcome local market failures in credit and insurance, allowing it to make better use of its resources through the remittances received.
6. Migration has both benefits and costs for the emitting community, the emitting country, and the recipient countries. They need to be carefully understood and managed to derive optimum benefit from migration and remittances.

With generally rapid population growth and insufficient creation of new employment opportunities, developing countries have a huge employment problem. Because labor is the main asset that poor people have, creating opportunities for them to use this asset productively is by far the main instrument for poverty reduction. No surprise, then, that providing employment opportunities in remunerative activities, elevating the level of skills of the labor force, and pacing migration between rural and urban destinations to avoid the expansion of urban slums is a major development issue. In this chapter, we first look at the logic of employment in the formal and informal sectors. We then look at two bodies of theory that aim at explaining why people migrate: one when the decision to migrate is taken at the individual level; the other when it is taken at the household level. We then consider international migration and look at the impact of migration at four levels: on the community from which the migrant came, on the country where domestic migration is happening, and on both the emitting and the receiving countries for international migration.

### I. Labor and employment

#### 1. The employment problem in developing and industrialized countries

The employment problem takes on different forms in different countries. In the developing countries, few people can afford to be openly unemployed. Because there is typically no formal social assistance provided to the unemployed, everybody has to in some way generate a living. This is the role of the informal sector. This is a sector where entry is easy, labor productivity is low, labor regulations such as paying the legal

minimum wage and respecting work safety codes are not enforced, taxes are not paid, social benefits are missing, and value added is generally not counted in GDP (though often guesstimated). Informal sector employment can range from self-employment in shoe-shining, selling lottery tickets on the sidewalk, and garbage recycling to employment in sweatshops where working conditions are hard, pay is low, social benefits are absent, and workers' rights are not recognized. Because the informal sector has easy entry, it provides a survival strategy to migrants. A symptom of the developing urban environment is thus a large informal sector, sprawling urban slums, lack of public services, and high congestion externalities. An important issue here is to induce more firms to enter into the formal sector, offering better employment conditions to their workers.

By contrast, the labor problem in industrialized countries is posed differently. In Europe, employment conditions tend to be rigid, union power is high, and social benefits comfortable. The labor problem is one of a relatively high rate of unemployment as employers are careful about hiring new workers that are expensive and that they will have a hard time to dismiss if needed. In the U.S., by contrast, employment is much more flexible, union power generally weak, and social benefits more limited. Jobs are often available on a part-time basis, with little if any social benefits. As a consequence, the labor problem is less one of employment than of remunerative wages for unskilled labor. Real wages have been falling steadily and disparities between skilled and unskilled have been rising steadily, contributing to the rise in inequalities. The labor problem in Europe is thus one creating more jobs, in the U.S. of creating better jobs.

## **2. Indicators of employment**

Given the fact that there is little open unemployment in developing countries due to lack of unemployment insurance and other formal safety nets, the employment problem is more one of under-employment. Characterizing employment requires other indicators, here applied to Colombia:

- Open unemployment: defined as people "actively seeking work". Colombia 5%.
- Hidden unemployment: defined as "discouraged workers". They are typically not counted in characterizing employment.
- Under-employment when people who do not work full time due to seasonal unemployment or to part-time work. Colombia 15%.
- Under-employment when people are working in very low productivity jobs relative to their skills and effort level. Colombia 13%.

Using these employment indicators, total un- and under-employment in Colombia is as much as 33%, when there is only 5% open unemployment.

## **3. Employment in the formal and informal sectors**

The formal and informal sectors are closely inter-related. As Hernando De Soto (1989) argued, excessive regulation in the formal sector can push economic activity into the informal sector. High wages paid in the formal sector, above the full employment equilibrium, also push employment into the informal economy. These high wages can be due to minimum wage legislation, payment of social benefits, labor unions, and "efficiency wages" whereby employers pay wages above the full-employment

equilibrium as a way of motivating effort among their workers (Akerlof and Yellen, 1986). In this latter case, unemployment serves as a disciplinary device, inducing worker effort under the threat of joining the unemployed. This can be seen in Figure 1. Workers that cannot find employment in the formal sector at the high set wage  $\bar{W}_M$  crowd into the informal economy, depressing wages  $W_i$  in that sector that becomes a refuge for the formally unemployed. The higher the formal sector wage, the lower the wage in the informal sector.

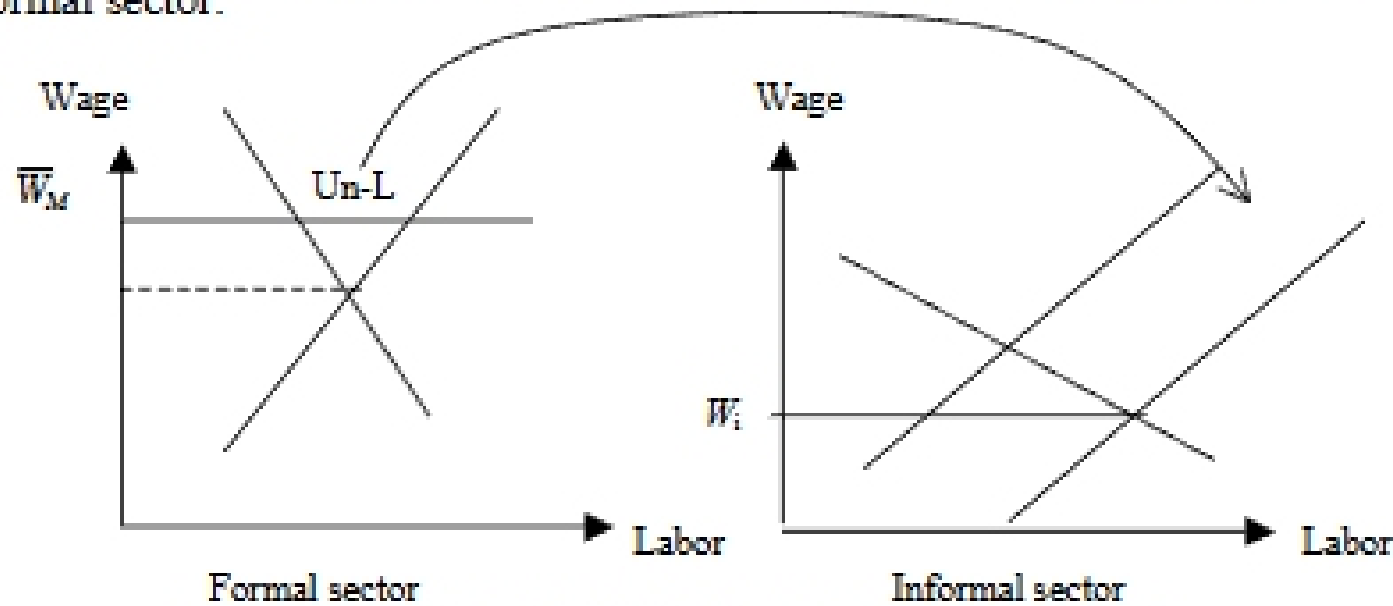


Figure 1. Wages in the formal and informal sectors

Surveys conducted by the International Labor Office (2002) have shown the tremendous importance of the informal economy. Recent estimates are that informal employment makes up 48% of non-agricultural employment in North Africa, 51% in Latin America, 65% in Asia, and 72% in Sub-Saharan Africa. Some 70% of informal sector workers are self-employed. ILO studies have also shown that the informal economy is highly heterogeneous. Part of it is disguised unemployment, a large refuge sector for workers unable to find employment in the formal sector. This sector tends to be counter-cyclical to formal sector employment. But part of the informal economy is highly complementary to the formal sector, with in particular subcontracts with formal sector firms. That part of the informal economy is pro-cyclical to formal sector employment. Expansion of social assistance programs, with access to non-contributory benefits, may induce more firms and workers to remain in the informal sector. Social assistance may thus have a perverse effect on informality, with the associated losses in economies of scale and productivity gains (Levy, 2008).

## II. Rural-urban migration

Migration is a huge phenomenon, involving million of people every year. Rural-urban migration contributed to increase the urban population from 29% of the world population in 1950, to 49% in 2005, and a predicted 60% in 2030. It is part of the normal process of “structural transformation”: as GDPpc rises, the labor force increasingly leaves agriculture and rural areas to move to urban environments and employment in industry and services. The decision to migrate responds to income ( $y$ ) differentials if  $y_{urban} > y_{rural}$ . Migration helps equilibrate the labor market, shifting labor toward higher productivity urban employment. In that sense, migration is “normal” and desirable. However, things are not that simple. Reality is that migration may be excessive if it creates congestion